TESTIMONY

OF

JAMES D. MCLAUGHLIN
FOR THE
THE AMERICAN BANKERS ASSOCIATION

BEFORE THE

SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW
COMMITTEE ON THE JUDICIARY
UNITED STATES HOUSE OF REPRESENTATIVES

REGARDING

THE KNOW-YOUR-CUSTOMER PROPOSAL

MARCH 4, 1999

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Subcommittee on Commercial and Administrative Law
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Mr. Chairman and members of the Subcommittee, I am James D. McLaughlin, Director, Regulatory and Trust Affairs, of the American Bankers Association, Washington, D.C. I am pleased to be here today to present the views of ABA on the federal banking regulators' current "Know Your Customer" proposal.

The ABA brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership – which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks – makes ABA the largest trade association in the country.

Mr. Chairman, the banking industry believes that preventing money laundering is an important tool in fighting illegal activities and our industry has consistently supported government efforts in this regard. In fact, government law enforcement officials have often complemented our industry on its efforts to fight money laundering. Nonetheless, the current proposal by federal bank regulators called "know your customer" goes far beyond a reasonable approach to this problem. In an effort to root out illegal activity, the proposal would require banks to gather information on and monitor the activities of ***all our customers.***

Certainly, this regulation poses an additional and unnecessary burden on banks, and further expands the regulatory imbalance with our competitors that would not have the same requirements. ***But there is a bigger issue at stake here – the privacy of our customers and the confidence they have in their financial institution.***

We thank you for holding this hearing today. It is an important step in assuring millions of bank customers that their privacy will be protected. It is becoming increasingly clear that Congress opposes these regulations. Last month the ABA took the unusual step in asking formally that the proposal be withdrawn. And the regulators themselves are saying that the proposal was a mistake. For example, Comptroller of the Currency John D. Hawke, Jr., just last week, told an ABA meeting that he could not support the proposal. This is not a partisan issue – conservatives and liberals have joined bankers and their customers in opposing this proposal.

Mr. Chairman, the ABA believes that the banking industry protects customer privacy better than any other industry in the United States. We have long protected customer information from unauthorized access, while fulfilling our mandate to report possible violations of law. Privacy is so important to the public and the industry, and the level of concern about this proposal is already so high and still growing, that no response short of withdrawing this proposal will serve the public interest. To do otherwise, we fear, will undermine confidence in both our industry and the government.

In my statement today, I would like to address three key concerns. The know-your-customer proposal:

- Has serious implications for maintaining the privacy of our customers;
- Would add costly and unnecessary regulatory burdens; and
- Would widen the gulf in regulatory treatment between banks and nonbanks.

I. Addressing the privacy concerns of our customers;

The greatest cause of industry and public opposition to the know-your-customer proposal has been its use of several broad terms or definitions. For example, some of the specific parts of the proposal (or in some instances, the preamble to the proposal) require a ***"system"*** to determine the ***source of funds for all customers*** and ***to know the normal and expected transactions of all customers***. The amount of information needed and the mandated eavesdropping required by the proposal raise great concerns about privacy. Media reports have focused especially on the profiling and monitoring wording, and privacy advocates have expressed outrage that their local banker will be required to analyze all customers' transactions.

This growing public view has so tainted the discussion of this regulation that simply deleting of the "profiling" term – as has been suggested – is not enough to calm the public's nerves. Questions would continue to be raised about the motivations of the government, and the public is unlikely to be consoled by simple word changes. While it is clear the authors of this proposal did not intend it to be read so broadly, we believe that the only option is to withdraw it completely.

The banking industry's reputation is built on trust, and protecting the privacy of our customers is fundamental to its preservation. We believe that no other industry in the United States does as much to protect privacy, while still fulfilling our obligations under the law to report possible criminal violations.[1] The know-your-customer proposal flips the delicate balance between our need to protect customer privacy and the obligation to report possible violations of law on its head. Confidence in both our industry and government must be preserved.

We recognize that broad policy issues remain that will need clarification. The policy debate on how to reconcile the inherent conflict between fraud prevention and money laundering deterrence, on one hand, and customer privacy, on the other hand, should continue.

Let me mention one worry bankers have. Even though the statute protects banks from civil liability for filing suspicious activity reports, the industry anticipates increased challenges under the guise of compromising customer privacy. While one recent court decision upheld this needed protection,[2] others have not. We urge Congress to consider additional provisions to ensure that banks which comply with the law are protected from customer suits -- for following the statutory mandate.

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[1] For a detailed summary of privacy law in the United States, see "Financial Privacy in America" on aba.com.

[2] On February 10, 1999, the U.S. Court of Appeals (2nd Cir.), in Lee v. Bankers Trust Company, found that 31 U.S.C. 5318 (g) protects a bank from customer lawsuits for filing a SAR.

II. The Know-Your-Customer Proposal Would Add Costly and Unnecessary Regulatory Burdens

Since 1984, banks – by law – have been required to report possible violations of federal law to the Treasury Department (which shares this information with federal and state law enforcement agencies) after the discovery of:

- insider abuse;
- any violations of any federal law; or
- potential money laundering activities.[3]

In fact, in a recent telephone poll, ABA found that close to 90 percent of banks currently employ procedures that they believe are adequate to meet the law enforcement needs that underlie the know-your-customer policy. Therefore, the banking industry is already supporting the stated law enforcement goal of establishing systems to deter fraud. While the agencies may have intended the December proposal to merely reflect industry practice, the proposal contains many elements that greatly exceed what is being done today, and these very provisions are the ones that have raised such public concern.

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[3]The criminal referral reporting regulations have been in effect since 1984. The successor to the 1984 criminal referral form requirements, the 1996 "Suspicious Activity Reporting" or SAR regulations were promulgated under 31 U.S.C. 5318 (g) and require banks to file with the Treasury Department reports of transactions which they suspect involve proceeds of illegal activity.

For example, the know-your-customer proposal fails to retain the current policy behind Suspicious Activity Reporting ("SAR") requirements – that of reporting a violation ***after*** it has occurred. The language of the new proposal replaces that policy with a new, vastly more expansive burden of ***investigating all customers*** to determine if anything illegal has taken place. While the regulators have stated that this is not what was intended, the language in the proposal makes this issue very real and of major concern to our members.

Moreover, as discussed above, there is great public concern and opposition to imposing a "system" to determine a customer's source of funds and a requirement to know the normal and expected transactions of all customers. While government spokespersons have stated that the intent is much narrower, the potential for huge costs and invasive practices is very high under the language of the proposed rule.

Profiling and monitoring customer transactions – again the subject of tremendous public rebuke – carries with it huge potential implementation and ongoing costs for banks. Some of our larger members are still gathering estimates on what it would cost to develop profiles for each existing and new customer, as well as to implement automated systems that would identify exceptions. One community bank estimated that the first full year of KYC implementation would cost the institution $110,000 without counting any automation upgrades, overtime or overhead.

III. The Know-Your-Customer Proposal Would Widen the Gulf in Regulatory Treatment Between Banks and Nonbanks.

Even if the know-your-customer proposal did not impose additional regulatory burden on banking institutions, the fact remains that the banking industry will be at a decided disadvantage with respect to our financial services competitors. This is because these competitors – which offer bank-like products – have no statutory obligation to meet suspicious activity requirements, let alone know-your-customer rules. To date, the National Credit Union Administration has not proposed a similar requirement for the nation's credit unions. In addition, securities and insurance firms will not be required to follow similar rules or file suspicious activity reports, ***while securities or insurance affiliates of banks*** must.[4]

This is bad public policy. Certainly, many privacy conscious customers will be led to believe that banks and their affiliates intrude into their privacy, while other financial institutions do not. One of the many community bank commenters stated this concern very succinctly:

> *We feel that this regulation, if adopted, could severely impact the banking system in a negative way because customers will not feel welcome at a bank and will go where they feel welcomed (credit unions, brokerage houses; i.e., anywhere that does not follow the regulation).*

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[4] The Treasury Department's bureau, the Financial Crimes Enforcement Network (FinCen), has been stating for some time, that they are planning to issue proposed regulations for suspicious activity reporting for securities firms and so-called "money services businesses" or "MSBs."

The net effect of this regulation may well be to further erode public confidence in banking institutions. Further, it places banks in a terribly awkward position between law enforcement and our legitimate customers.

In addition, compliance experts in our industry are interested in how to achieve more uniformity in the examination process, and all sides should address the competitive inequalities relative to suspicious activity reporting. As recently as January 22, the FRB[5], FDIC and OCC staff heard from over forty bankers about their concerns regarding the scope of the proposed rulemaking. The meeting attendees recommended the agencies continue to receive input on these important issues. The ABA concurs with this recommendation.

Conclusion

Mr. Chairman, thank you for allowing us to express our views on this important proposal. We take seriously the public's perception that the know-your-customer rule is an invasive and burdensome requirement. The American Bankers Association appreciates the willingness of the federal banking agencies to meet with interested groups to discuss the scope of the know-your-customer proposal. However, despite constructive dialogues over the critical issues, it has become clear to us that the current proposal should be withdrawn.

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[5] The staff of the Federal Reserve Board is to be especially commended for its diligence in agreeing to meet with over 20 bank associations at the state and federal levels during this comment period.